

under section 551(b) and § 1.551-2. Undistributed foreign personal holding company income is the taxable income of the foreign personal holding company, as defined in section 63(a) (computed without regard to subchapter N, chapter 1 of the Code), and adjusted in the manner described in section 556(b) and § 1.556-2, less the deduction for dividends paid (§§ 1.561-1 through 1.565-6). See § 1.556-3 for an illustration of the computation of undistributed foreign personal holding company income.

§ 1.556-2 Adjustments to taxable income.

(a) *Taxes*—(1) *General rule.* (i) In computing undistributed foreign personal holding company income for any taxable year, there shall be allowed as a deduction the Federal income and excess profits taxes accrued during the taxable year except that no deduction shall be allowed for (a) the accumulated earnings tax imposed by section 531 (or a corresponding section of a prior law), (b) the personal holding company tax imposed by section 541 (or a corresponding section of a prior law), and (c) the excess profits tax imposed by subchapter E, chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940. The deduction is for taxes for the taxable year determined under the accrual method of accounting, regardless of whether the corporation uses an accrual method of accounting, the cash receipts and disbursements method, or any other allowable method of accounting. In computing the amount of taxes accrued, an unpaid tax which is being contested is not considered accrued until the contest is resolved.

(ii) However, the corporation shall deduct taxes paid, rather than taxes accrued, if it used that method with respect to Federal taxes for each taxable year for which it was subject to the provisions of supplement P, subchapter C, chapter 1 of the Internal Revenue Code of 1939, unless an election is made under subparagraph (2) of this paragraph to deduct taxes accrued.

(2) *Election by corporation which deducted taxes paid.* (i) If the corporation was subject to supplement P, subchapter C, chapter 1 of the Internal Revenue Code of 1939, and, for the pur-

pose of computing undistributed supplement P net income under such Code, deducted Federal taxes paid, rather than such taxes accrued, for each taxable year for which it was subject to supplement P of the 1939 Code, the corporation may elect for any taxable year ending after August 16, 1954, to deduct taxes accrued, rather than taxes paid, for the purpose of computing its undistributed foreign personal holding company income. The election shall be made by deducting such taxes accrued in the return (Form 958) required to be filed for such taxable year. The return shall, in addition, contain a statement that the corporation has made such election and shall set forth the year to which such election was first applicable. The deduction of taxes accrued in the year of election precludes the deduction of taxes paid during such year. The election, if made, shall be irrevocable and the deduction for taxes accrued shall be allowed for the year of election and for all subsequent taxable years. See section 6035 and the regulations thereunder for rules relative to the filing of returns of officers, directors, and shareholders of foreign personal holding companies.

(ii) Pursuant to section 7851(a)(1)(C), the election provided for in subdivision (i) of this subparagraph may be made with respect to a taxable year ending after August 16, 1954, even though such taxable year is subject to the Internal Revenue Code of 1939.

(3) *Taxes of foreign countries and United States possessions.* In computing taxable income, a foreign personal holding company is allowed a deduction under section 164 for income, war profits, and excess-profits taxes paid or accrued during the taxable year to foreign countries or possessions of the United States, but is not allowed the foreign tax credit under section 901. Therefore, in computing undistributed foreign personal holding company income for any taxable year, no adjustment under section 556(b)(1) is allowed for such taxes.

(b) *Charitable contributions*—(1) *Taxable years beginning before January 1, 1970.* (i) Section 556(b)(2) provides that, in computing the deduction for charitable contributions for purposes of determining the undistributed foreign

personal holding company income of a corporation for taxable years beginning before January 1, 1970, the limitations in section 170(b)(1)(A) and (B), relating to charitable contributions by individuals, shall apply and section 170(b)(2) and (5), relating to charitable contributions by corporations and carryover of certain excess charitable contributions made by individuals, respectively, shall not apply.

(ii) Although the limitations of section 170(b)(1)(A) and (B) are 10 and 20 percent, respectively, of the individual's adjusted gross income, the limitations are applied for purposes of section 556(b)(2) by using 10 and 20 percent, respectively, of the corporation's taxable income as adjusted for purposes of section 170(b)(2), that is, the same amount of taxable income to which the 5-percent limitation applied. Thus, the term *adjusted gross income* when used in section 170(b)(1) means the corporation's taxable income computed with the adjustments, other than the 5-percent limitation, provided in the first sentence of section 170(b)(2). However, a further adjustment for this purpose is that the taxable income shall also be computed without the deduction of the amount disallowed under section 556(b)(5), relating to expenses and depreciation applicable to property of the taxpayer, and section 556(b)(6), relating to taxes and contributions to pension trusts, and without the inclusion of the amounts includible as dividends under section 555(b), relating to the inclusion in gross income of a foreign personal holding company of its distributive share of the undistributed foreign personal holding company income of another company in which it is a shareholder. The carryover of charitable contributions made in a prior year, otherwise allowable as a deduction in computing taxable income to the extent provided in section 170(b)(2) and, with respect to contributions paid in taxable years beginning after December 31, 1963, in section 170(b)(5), shall not be allowed as a deduction in computing undistributed foreign personal holding company income for any taxable year.

(iii) See § 1.170-2 with respect to the charitable contributions to which the 10-percent limitation is applicable and

the charitable contributions to which the 20-percent limitation is applicable.

(2) *Taxable years beginning after December 31, 1969.* (i) Section 556(b)(2) provides that, in computing the deduction allowable for charitable contributions for purposes of determining the undistributed foreign personal holding company income of a corporation for taxable years beginning after December 31, 1969, the limitations in section 170(b)(1)(A), (B), and (D)(i) (relating to charitable contributions by individuals) shall apply, and section 170(b)(1)(D)(ii) (relating to excess charitable contributions by individuals of certain capital gain property), section 170(b)(2) (relating to the 5-percent limitation on charitable contributions by corporations), and section 170(d) (relating to carryovers of excess contributions of individuals and corporations) shall not apply.

(ii) Although the limitations of section 170(b)(1)(A), (B), and (D)(i) are 50, 20, and 30 percent, respectively, of an individual's contribution base, these limitations are applied for purposes of section 556(b)(2) by using 50, 20, and 30 percent, respectively, of the corporation's taxable income as adjusted for purposes of section 170(b)(2), that is, the same amount of taxable income to which the 5-percent limitation applies. Thus, the term *contribution base* when used in section 170(b)(1) means the corporation's taxable income computed with the adjustments, other than the 5-percent limitation, provided in section 170(b)(2). However, a further adjustment for this purpose is that the taxable income shall also be computed without the deduction of the amount disallowed under section 556(b)(5), relating to expenses and depreciation applicable to property of the taxpayer, and section 556(b)(6), relating to taxes and contributions to pension trusts, and without the inclusion of the amounts includible as dividends under section 555(b), relating to the inclusion in gross income of a foreign personal holding company of its distributive share of the undistributed foreign personal holding company income of another company in which it is a shareholder. The carryover of charitable contributions made in a prior year, otherwise allowable as a deduction in

computing taxable income to the extent provided in section 170(b)(1) (D) (ii) and (d), shall not be allowed as a deduction in computing undistributed foreign personal holding company income for any taxable year.

(iii) See §1.170A-8 for the rules with respect to the charitable contributions to which the 50-, 20-, and 30-percent limitations apply.

(c) *Special deductions disallowed.* Part VIII, subchapter B, chapter 1 of the Code allows corporations special deductions in computing taxable income for such matters as partially tax-exempt interest, certain dividends received, dividends paid on certain preferred stock of public utilities, organizational expenses, etc. See section 241. For purposes of computing undistributed foreign personal holding company income, such special deductions, except the deduction provided by section 248 (relating to organizational expenditures) and, with respect to such a computation for a taxable year ending before January 1, 1958, the deduction provided by section 242 (relating to partially tax-exempt interest), shall be disallowed.

(d) *Net operating loss.* The net operating loss deduction provided in section 172 is not allowed for purposes of the computation of undistributed foreign personal holding company income. For purposes of such a computation, however, there is allowed as a deduction the amount of the net operating loss (as defined in section 172(c)) for the preceding taxable year, except that, in computing undistributed foreign personal holding company income for a taxable year ending after December 31, 1957, the amount of such net operating loss shall be computed without the deductions provided in part VIII (section 241 and following) except section 248, relating to organizational expenditures, subchapter B, chapter 1 of the Code.

(e) *Expenses and depreciation applicable to property of the corporation.* (1) Section 556(b)(5) provides a specific limitation in computing undistributed foreign personal holding company income, with respect to the allowance of deductions for trade or business expenses and depreciation which are allocable to the operation and maintenance of property

owned or operated by a foreign personal holding company. Under this limitation these deductions shall not be allowed in excess of the aggregate amount of the rent or other compensation received for the use of, or the right to use, the property, unless it is established to the satisfaction of the Commissioner:

(i) That the rent or other compensation received was the highest obtainable, or if none was received, that none was obtainable;

(ii) That the property was held in the course of a business carried on bona fide for profit; and

(iii) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

(2) The burden of proof will rest upon the taxpayer to sustain the deduction claimed. If a United States shareholder, in computing his distributive share of undistributed foreign personal holding company income to be included in gross income in his individual return (see section 551, and §§1.551-1 and 1.551-2), claims deductions for expenses and depreciation allocable to the operation and maintenance of property owned or operated by the company, in an aggregate amount in excess of the rent or other compensation received for the use of, or the right to use, the property, he shall attach to his income tax return a statement setting forth his claim for allowance of the additional deductions, together with a complete statement of the facts and circumstances pertinent to his claim and the arguments on which he relies. Such statement shall set forth:

(i) A description of the property;

(ii) The cost or other basis to the corporation and the nature and value of the consideration paid for the property;

(iii) The name and address of the person from whom the property was acquired and the date the property was acquired;

(iv) The name and address of the person to whom the property is leased or rented, or the person permitted to use the property, and the number of shares of stock, if any, held by such person and the members of his family;

(v) The nature and gross amount of the rent or other compensation received for the use of, or the right to use, the property during the taxable year and for each of the five preceding years and the amount of the expenses incurred with respect to, and the depreciation sustained on, the property for such years;

(vi) Evidence that the rent or other compensation was the highest obtainable, or, if none was received, a statement of the reasons therefor;

(vii) A copy of the contract, lease or rental agreement;

(viii) The purpose for which the property was used;

(ix) The business carried on by the corporation with respect to which the property was held and the gross income, expenses, and taxable income derived from the conduct of such business for the taxable year and for each of the five preceding years;

(x) A statement of any reasons which existed for expectation that the operation of the property would be profitable, or a statement of the necessity for the use of the property in the business of the corporation, and the reasons why the property was acquired; and

(xi) Any other information pertinent to the taxpayer's claim.

(f) *Taxes and contributions to pension trusts.* Section 164(e) provides for deduction by a corporation for taxes of a shareholder paid by it; section 404 provides for deduction by an employer for its contributions to an employees' trust, etc. For the purpose of computing undistributed foreign personal holding company income, neither of these deductions is allowable.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7207, 37 FR 20796, Oct. 5, 1972]

§ 1.556-3 Illustration of computation of undistributed foreign personal holding company income.

The method of computation of the undistributed foreign personal holding company income may be illustrated by the following example:

Example. (a) The following facts exist with respect to the M Corporation, a foreign personal holding company, for the calendar year 1954:

(1) The gross income of the corporation as defined in section 555 amounts to \$300,000, of which \$85,000 represents its distributive share of the undistributed foreign personal holding company income of another foreign personal holding company in which it is a shareholder, \$200,000 consists of dividends, \$10,000 consists of fully taxable interest, and the remainder (\$5,000) consists of rent received from the principal shareholder of the corporation for the use of property owned by the corporation.

(2) The expenses of the corporation amount to \$85,000, of which \$75,000 is allocable to the maintenance and operation of the property used by the principal shareholder and \$10,000 consists of ordinary and necessary office expenses allowable as a deduction. The claim for deduction for the expenses of, and depreciation on, the rented property in excess of the rent received for its use is not established as provided in section 556(b)(5). The yearly depreciation on the rented property amounts to \$30,000.

(3) Federal income tax withheld at the source on the income of the corporation from sources within the United States amounts to \$59,125.

(4) No gain from the sale or exchange of stock or securities is realized during the taxable year, but losses in the amount of \$10,000 are sustained from the sale of stock or securities which constitute capital assets. Such losses are not allowed as a deduction in any amount. See section 1211(a).

(5) Contributions, payment of which is made to or for the use of donees described in section 170(b)(1)(A) for the purposes therein specified, amount to \$15,000, of which \$5,000 is deductible in computing taxable income under section 63.

(6) Dividends paid by the corporation to its shareholders during the taxable year amount to \$50,000.

(b) The taxable income of the corporation (including the distributive share of the undistributed foreign personal holding company income of the other foreign personal holding company) is \$180,000, computed as follows (assuming for the purposes of this example only that the expenses of, and depreciation on, the rental property are deductible under sections 162 and 167):

<i>Income (Section 61)</i>	
Dividends	\$200,000
Interest	10,000
Rent	5,000
Gross income as defined in section 61	215,000
Add:	
Distributive share of undistributed income of the other foreign personal holding company (considered as a dividend)	85,000
Gross income as defined in section 555	300,000